DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92038

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July 16, DJIA 993.21; PTI 650; A-D Ratio -22.18
July 23, DJIA 990.91; PTI 655; A-D Ratio -22.46

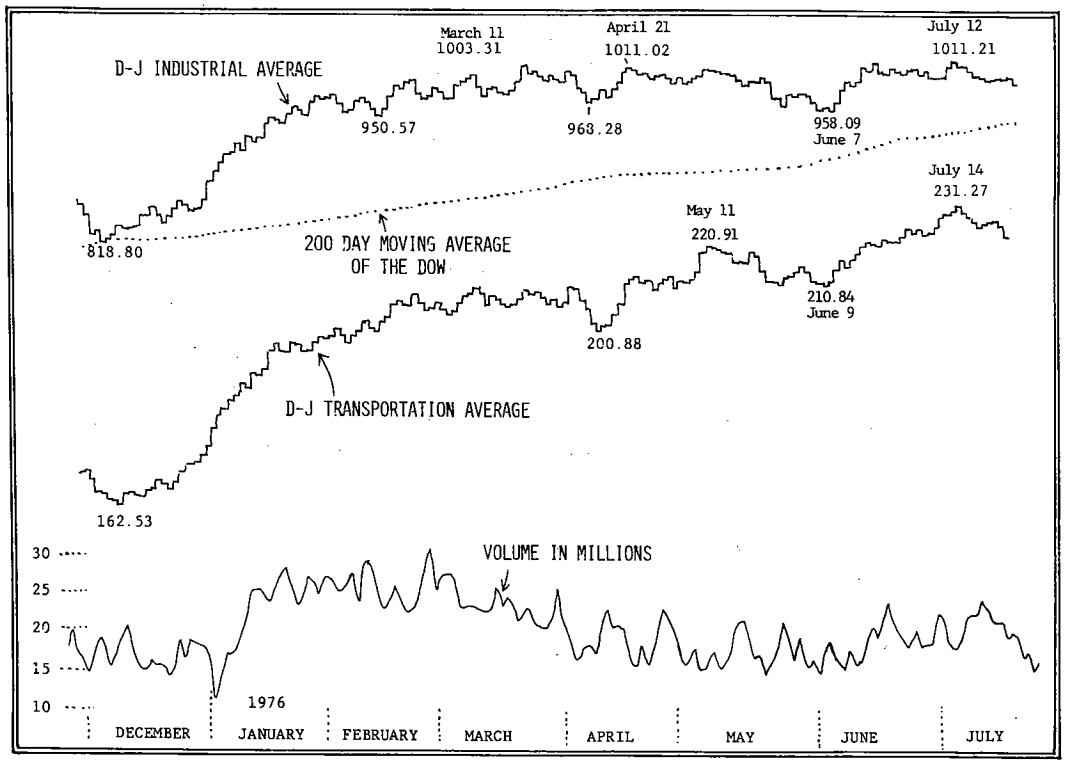
UNUSUAL TIMES: The upward momentum of retail sales, industrial production, profits, is slowing. Liquidity is building up at the banks, the corporations, and at the consumer level. No one is terribly excited about anything (even the Bicentennial fever has died out). Employment decreased in June, while unemployment inched up. Commodity prices have broken (see later section), the foreign car boom has slowed substantially, as has the compact car fascination. Talk of the energy crisis has died down to a dull murmur, and Jimmy Carter is "cooling it" in favor of a lower profile. Mr. Ford, as usual, is not saying anything for the ages. It's "resting time" in the U.S.

I believe this caution is basically constructive. The stock market has seen it coming; it saw it as far back as last February, when the Averages decided to go into their sleepwalking act. Wall Street has been hibernating for five months now. Consequently, I've been suggesting a diet of watchful waiting, patience and more patience.

But while I've been urging all this patience, certain concepts are becoming clear. (1) Inflation does not seem to be a threat over the foreseeable future. (2) Bonds, now offering average yields of almost 5% above average stock yields, are very attractive. (3) Corporate profits are still rising strongly, and liquidity is building up. This is basic bull market material. (4) The current "do nothing" markets are making hash of the option buyers. (5) The conservative economic and market trends are negative influences on gold. (6) Utility stocks, currently on a high yielding basis, are beginning to outperform the market. (7) The current second (psychological) phase of the bull market is being extended, due to the dearth of speculative sentiment. (8) Stock markets and economies don't often collapse following periods of dullness, periods such as the current one.

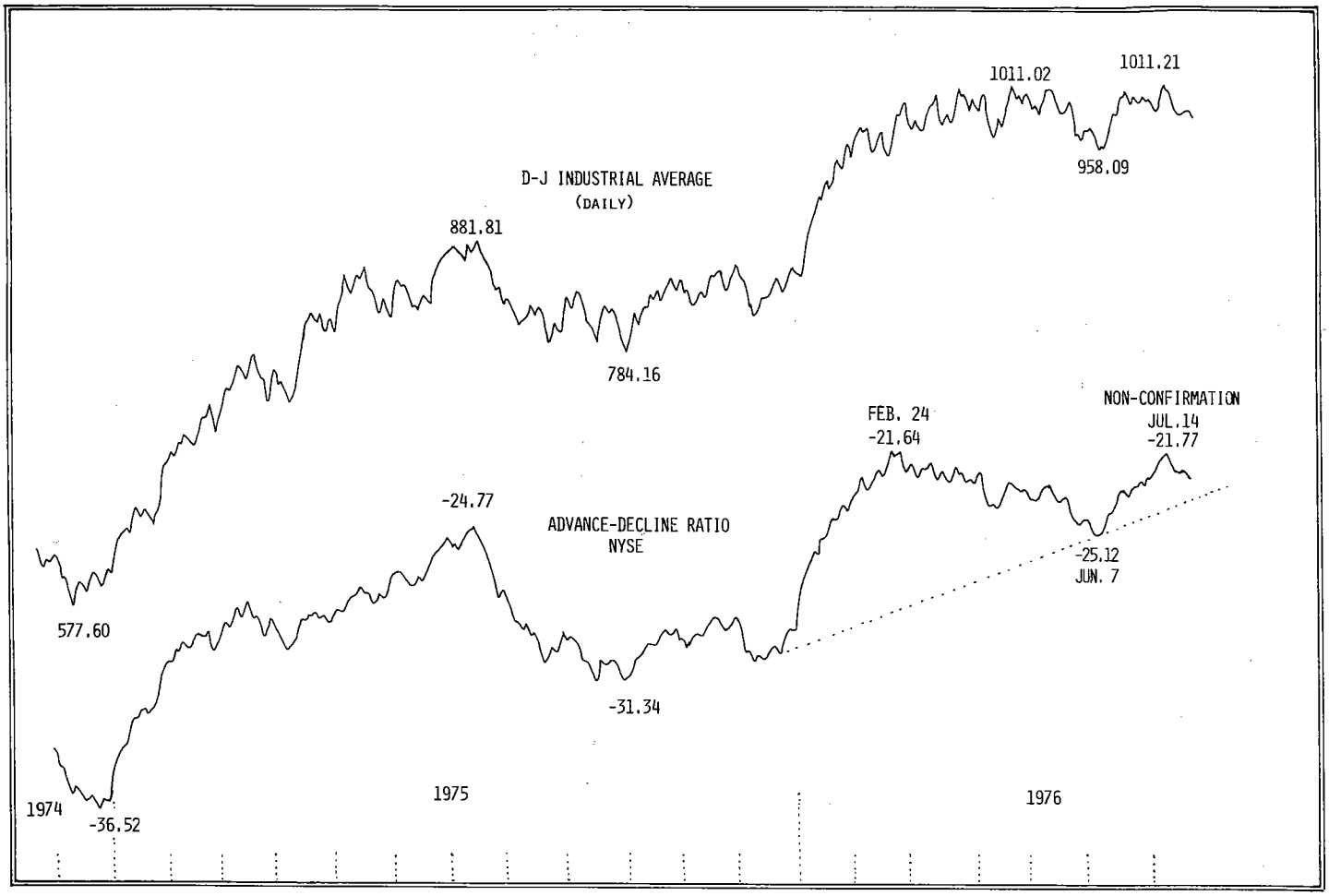
Conclusion: I feel that we are in a constructive, extended period of non-speculative non-action. I think that this is what we need for the good of the nation, for the good of our economic structure (and for the good of the markets, which are simply reflecting all this). To my mind, the single most bullish development from here would be a rising bond market. So far, all my bond indices look bullish.

THE TREND: In difficult, trendless or exasperating markets, I always turn to the study which has helped me most over the past quarter century. That study is the venerable Dow Theory. So let's go to the Theory again. From the standpoint of the Dow Theory, we note that since mid-April the Transportation Average (see chart below) has been working its way steadily higher. The peak for the year came on July 14 at 231.27. The Industrial Average, on the other hand, has not shown anything like the strength of the Transports. Four months ago, on March 11, the senior Average recorded a peak of 1003.31. Since then, the Industrials have moved essentially sideways.



Ironically, however, Industrials have managed to advance the 8 points required to confirm the action of the Transports. On July 12 the Industrial Average closed at 1011.21, the bearest fraction above its April 21 peak of 1011.02. This weak little upward thrust satisfied those who follow Dow's Theory on a purely mechanical basis, but I do not include myself in this group. Much can be inferred from the manner in which the Averages confirm each other: whether volume expands, whether there is a real follow-through, whether the Averages develop momentum in the direction of the confirmation.

On every count, the confirmation of July 12 was a disappointment. Nevertheless, it would



be worthwhile at this point to retain our constructive view while allowing the market itself to tell its own story. If the situation is deteriorating, if the secondary trend is turning down, we will know it soon enough. There have been many instances in the past in which one Average or the other has given a belated confirmation (as on July 12). The market has then backed off, volume has dried up on the decline, and finally the real upward movement materialized. This kind of sequence could be in the process now.

At this point the reader may be saying, "This Russell isn't predicting a damn thing. He's just waiting to see what the market is going to do next. I can read the Wall Street Journal too, so who needs the bum! " To which I say that I refuse to indulge in quackery. I'm not one of those "perpetual prophets" who always offer you a forecast for tomorrow, next week, and next month. And, of course, the usual tally for such practitioners is around 50% of the forecasts right and 50% wrong (and the record is often not that good).

In my experience, I note that the market is actually "telling us something" about 10% to 20% of the time, while 80% of the time it is being deceptive, doing nothing, or following some minor and often meaningless trend. During those do-nothing periods I adhere to the Dow Theory principle which states that the last trend is conceded to be in force—until proved differently. This concept may sound naive or even ridiculous, but I have seen it generate profits and avoid losses time after time, year after year.

PRICE-BREADTH: Once again I want to discuss the relationship of price (the Dow Industrial Average) and breadth (the A-D ratio on the NYSE). The thirty Dow stocks represent thirty giant US corporations, the value of which is better than a quarter of the value of the entire NYSE. On the other hand, the A-D ratio is representative of the action of the entire market, and it is composed of the differential of the advances and declines (daily) divided by the total number of issues traded each day.

A study of history demonstrates that the paths of the Dow and the A-D Ratio tend to move in harmony. In healthy advancing phases, the two indicators move above preceding peaks and hold above preceding low points. During bearish declining phases, preceding lows are broken while preceding peaks are not bettered. This is the harmonious aspect of price-breadth action.

Whenever non-confirmations appear, we can expect reversals of the trend. Where a series of non-confirmations occur (divergences), we can expect major reversals of trend. In most instances, a period of disharmony or divergence results in a reversal which usually erases the entire movement which produced the disharmony.

I include on this page a chart which traces the daily action of the Dow and the A-D from the beginning of this bull market (December, 1974) to present. In general, price and breadth held in gear from December '74 to February '76. There were a few

minor discrepancies and belated confirmations, but for the most part the Dow and the A-D advanced and declined as if they were meshed together.

The last confirmed peaks in price and breadth occurred on February 24, 1976. On that day the A-D Ratio topped at -21.64 while the Dow recorded a close of 993.55. Two months later, on April 21, the Dow recorded a new peak of 1011.02. The A-D Ratio (see chart) refused by a wide margin to confirm. Five months after the February 24 peak, on July 12, the Dow hit another new peak of 1011.21. Again the A-D failed to confirm, but this time by a much narrower margin. Then, while the Dow sold off, the A-D rallied for two additional days. On July 14 the A-D ratio touched a high of -21.77, exactly 13/100's below the February 24 peak.

On a cold reading of the technical data, we now have our first major period of price-breadth disharmony (divergence) since the bull market began. In Letter 668 I reviewed a number of instances in which the Dow recorded new highs many months after a peak in the A-D Ratio. The record of market action subsequent to these "long lag non-confirmations" is not particularly inspiring. In fact, only the 1963 experience stands out as a long lag non-confirmation which saw the market straighten itself out on the upside (with a resultant major rise to follow).

If this was a primary bear market, I would be writing "danger" on every page of this report. But we are now in a bull market that is less than two years old. Bank liquidity is building, the economy is far from heating up, and there are few signs of over-speculation on Wall Street. It is very easy to "take the money and run" during every divergence, non-confirmation or hint of trouble in a bull market. I would like to avoid that kind of precipitous (and very possibly incorrect) action. So I'll say it again: in a bull market I follow a policy of giving the uptrend every benefit of the doubt.

Ideally, of course, what I would "like" to see is the Dow and the A-D push up above their respective 1976 highs (the A-D above the February 24 peak, the Dow above the 1011.21 peak of July 12). If that kind of action took place, I personally would utter a sign of relief.

On the negative side, I want to define what I consider to be the potential danger points. Note on the chart that I have drawn a trendline connecting the December (1975) and June (1976) lows in the A-D ratio. I would not like to see that trendline broken. But if it is broken, I would hope that the A-D could hold above the June low of -25.12. If that point was also penetrated, I would guess that at best, we were in for a long, frustrating Fall and Winter season—and very probably a costly one.

Question: What do you think the real meaning of this price-breadth divergence is? Answer: On the hopeful side, it might simply be part of the broad, five month market stall-out. The market has put itself in a position where it does not gather a following on rallies, yet the declines do not bring in any serious selling. Obviously, Wall Street has reservations about the picture ahead. I would call this a market attitude one of "skeptical optimism." Under this interpretation, once the waiting period is over, all could be well and we could have a good resolution on the upside.

The negative interpretation would be that the majority of NYSE issues are facing too many assorted troubles at this time, and the breadth index simply reflects those collective troubles. I have said before that the 30 giant Dow Industrials can carry the market for just so long, but ultimately the roughly 1600 other common stocks have to make it on the upside too. Until or unless the A-D ratio can better its February 24 high, the inference is that today's "prosperity" is too selective. Persistent selectivity is almost always a forerunner of trouble in the market. So let's hope today's selectivity broadens out to give us a new high in the A-D Ratio.

MOVING AVERAGES: One of the studies which I have found useful over the years is that of the three moving averages of the Dow Industrials. For purposes of this study, I use a short-term or 4-week MA, a medium-term or 13-week MA, and a long-term or 50-week MA.

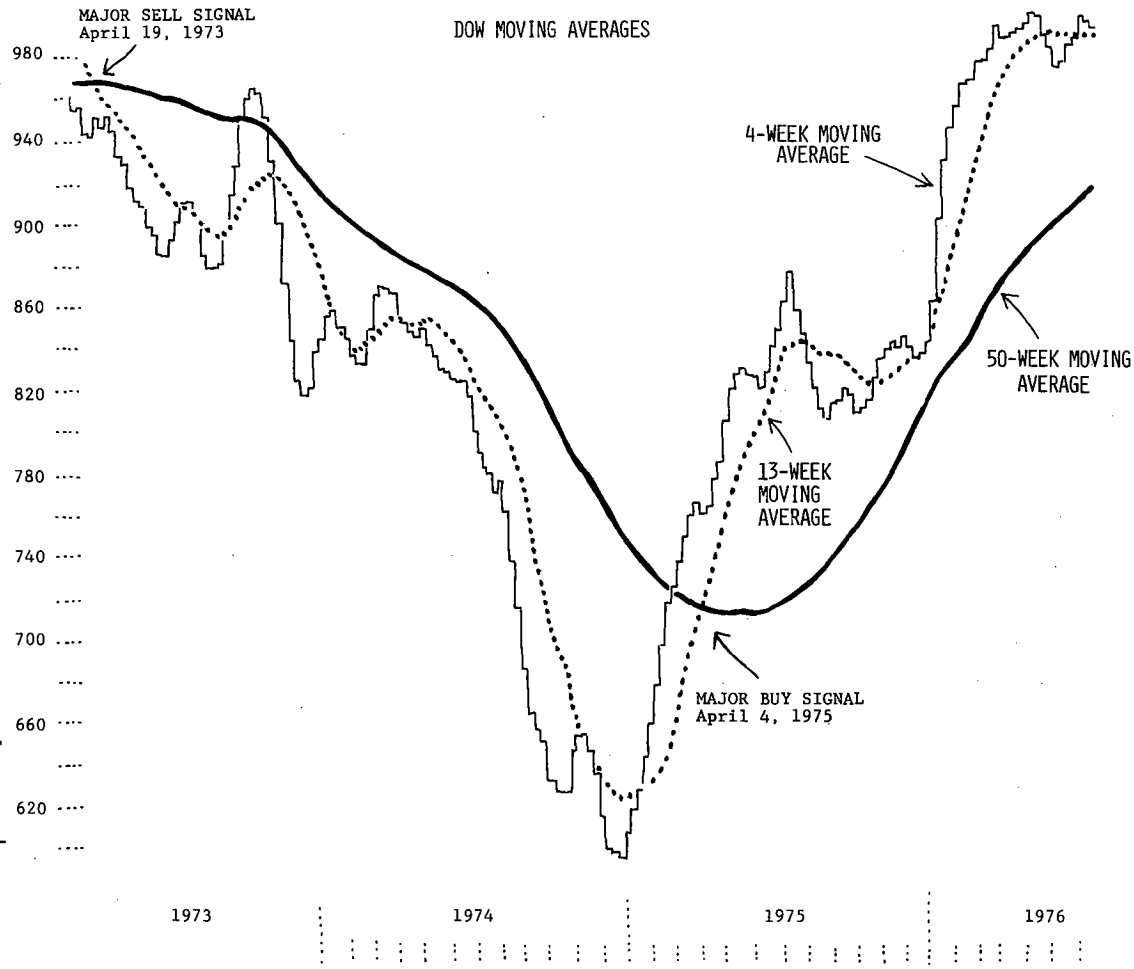
Each of the MA's is identified on the chart, and the MA tabulations are posted once a week. First, readers should understand that this study (like all market studies) is not infallible, but I give it most credence when "signals" are in harmony with the primary direction of the market.

Buying and selling "alerts" are provided when the 4-week MA crosses above or below the 13-week MA. Major buy and sell signals are given when the 13-week MA breaks above or below the 50-week MA. The alert signals may come at frequent intervals (often three or four in a year), and they often produce whip-saws if you follow them on a trading basis. Nevertheless, by construction a sell alert must come before a sell signal, and a buy alert must come before a buy signal. To this extent, the alert signals are important.

Note that only one major buy signal and one major sell signal has been given under this study since 1973. Had one obeyed the sell signal, he would have avoided the worst bear market smash since 1937.

The bear market bottom (under Dow Theory) occurred in December, 1974, at 577.60. This service recommended buying within a week or so of the extreme bottom, that buying being based on the implications of Dow's Theory. The first buy alert in the new bull market occurred when the 4-week MA crossed above the 13-week MA in mid-January, 1975 (with the Dow at 620). The major buy signal came on April 4, 1975, when the 13-week MA rallied above the 50-week MA (see chart). That buy signal arrived with the Dow at 620. Had the market student obeyed the 1975 buy alert and the major buy signal, he would have been invested in one of the greatest and most explosive advances in stock market annals.

All of which brings us to the present. Since April, 1975, there have been no sell signals. The major buy signal of 1975 is there-



fore still in force. Currently, the 4-week MA is at 994, just 4 points above the 13-week MA, which stands at 990. The 13-week MA, in turn, is 72 points above the 50-week MA, which currently stands at 920.

Projecting a bit, there is a chance that we will receive a sell alert in the next week or so. But it would take many weeks of downside action to produce a major sell signal. So from the standpoint of the long-term or primary trend investor, the MA studies are intact.

I don't know any formula or perfect system for beating the stock market. And I have never found any method (technical or otherwise) for eliminating intuition, common sense and "feel" from my interpretations of the stock market. So at the moment, I am watching the moving averages study of the Dow just as I am watching dozens of other devices and indicators, all in an effort to determine the most prudent and intelligent course of action.

As I said in the A-D section, I hope everything straightens out. I hope that what we're seeing here in 1976 is simply a consolidation of the great gains that the market registered during 1975 and early 1976. If some of the indices start "creaking," if we start getting a few major sell indications, I will advocate some scaling back, and a general position of defensiveness.

I know full well that the stock market "can do anything." Paying the cost of insurance has never bothered me, and one can always repurchase stocks that have been sold for insurance purposes. To many, a good night's rest is more important than potential profits, and there's nothing wrong with that attitude.

It has been said that "a man doesn't get rich making money, he gets rich keeping his money." Everyone you know who has a fat list of assets is a "survivor." He has won the investment battle. He has survived the onslaughts of Wall Street, the various con men who call daily, the wide-eyed salesmen, the get-rich-quick operators, the poor investment advice, and his own greedy and fearful instincts. It's not easy to keep what you've earned, but study, humility, patience and intelligence will usually win the battle.

NOTES: An interesting quote: "The true republic—men, their rights and nothing more. Women, their rights and nothing more." Susan B. Anthony.

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According to an Assoc. Press story, posters tell us where it's at. The latest trend in posters is to beauty, peacefulness, rather than protest. Big sellers today are Renoirs, Rembrandts, peace motifs, nostalgia posters. The fists, the Watergate protests, the "burn-it-down" items are out. Said one leading poster store, "Today, people just want to sit and look at something pretty." That kind of attitude could opt for a "caretaker" type President such as Mr. Ford.

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How time changes mens' thinking. Whereas the Fathers of our nation espoused gold-backed money, today's liberals are all for paper. Whereas the most important document in American history, the Declaration of Independence, states not once but twice that it is the people's right and duty to throw off tyrranical government, today's liberals want government to plan everything including our own lives. Whereas the right to bear arms is an absolute must if the people are to retain the ultimate power to overthrow tyrrany (to say nothing of protecting themselves), today the liberals are all for "gun control," a euphemism for banning guns. I have noted that all dictatorships start with three actions, (1) censoring or taking over the news sources, (2) prohibiting citizens from holding gold, (3) prohibiting gun ownership. People without the right to the news, the right to hold gold and the right to hold arms, are incipient slaves. The Declaration of Independence, in my mind, is a meaningless piece of paper once the government has the power, the guns and the news all on its side.

* * *

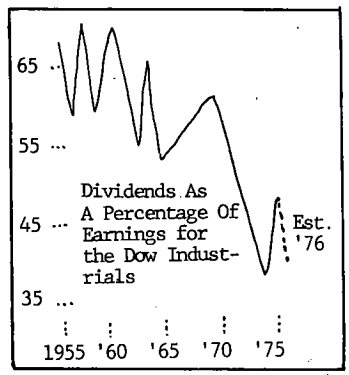
S. Africa has given a leading ad agency a $4 million contract to talk up gold. One reason could be the Krugerrand story. Sales of Krugerrands have dropped 44% during first half 1976 compared with first half 1975.

I have said before that the gold picture has changed. When the US is strong, gold is a sale, and when the US is weak, gold is a buy. Even such "conservatives" as Fed Chairman Burns and Treasury Secretary Simon rejoiced when gold fell out of bed last week (although Mr. Burns had second thoughts).

The dollar has been firming against world currencies and the US economy is now about as strong as any economy in the world. The dollar is currently a wanted currency, and as long as the dollar is strong and people have faith in it, they are going to prefer it (along with its very attractive interest rates) to gold. After all, it costs you 8% to 10% in lost interest to hold gold now, plus the agony of hanging on to a diminishing asset. Only limited "survival positions" should be held in gold as long as the dollar is strong. Pro-gold France, wracked by inflation, is seeing its franc slide to low after low against the dollar.

* * *

One of the plusses that I see for the market now is the low payout in the big Dow stocks. This chart (courtesy of Business Week) shows that during the late-1950's the Dow dividend payout as a percentage of earnings was up around the two-thirds level. The current payout is nearer the one-third level. This means that either corporate liquidity is building up (as earnings are re-invested) or that there is much room for dividend boosts—or both.



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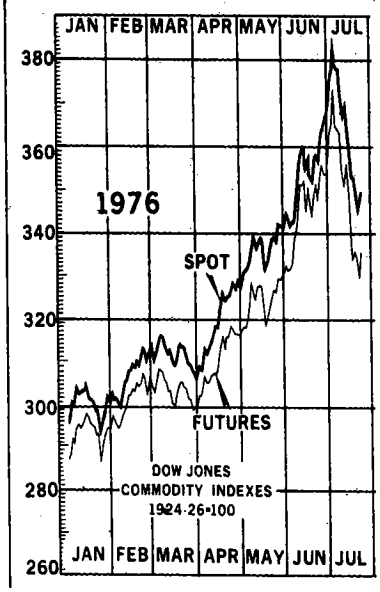
According to excellent sources in the Money Manager, if Jimmy Carter wins the election, Arthur Burns will quit the Fed. In that event, I would guess that almost anyone Carter appointed as Fed Chairman would be less than attractive to Wall Street than Burns. Burns is widely conceded to be a bastian against inflation.

* * *

The sudden and violent shakeout (if you are in it you call it a "collapse") in commodities has certainly lowered inflation expectations (see WSJ chart). Many agricultural commodities have dropped the daily limit for days on end. What has happened? For one thing, the big, optimistic inventory buildup of first half 1975 has run into less than sparkling business conditions during 1976. Thus, manufacturers have now halted the big inventory expansion. Also, the talk of terrible crop shortfalls sent commodity prices careening upwards. But now, with the help of giant plantings and a bit of rain, it appears there will be crop surplusses. On top of this, Russia has found its credit impaired at the banks. Consequently, Russia has been selling gold for hard cash. This has helped knock down the gold price. Finally, S. Africa, now running a whopping deficit, has been selling all her gold output. Result, gold and commodities are weak, business outlook is all right but not rosy, and the dollar is strong.

COMMODITY INDEXES



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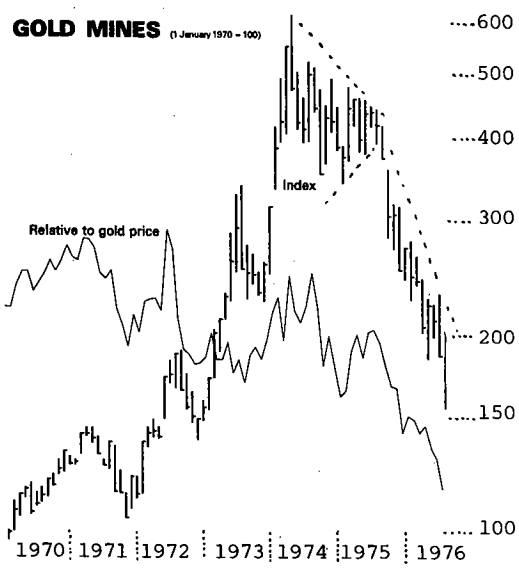
I thought the Olympics were great, but how's this for comparisons. The 1932 Olympics in Los Angeles cost LA City and County $1 million, financed by a bond issue. LA came away with a profit of $200 thousand. The 1976 Montreal Olympics cost roughly $1.5 billion, and the deficit is going to be $1 billion. The security budget in Montreal alone cost 100 times what the entire LA Olympics cost. Conclusion: the policiticans in Canada are "off their rockers."



GOLD: Since the last report, gold broke to 107, then rallied to the 114 level. In breaking to 107, gold smashed the halfway level of the entire rise from the 35 price of 1970 to the 200 price of 1974. That halfway level was 117. Technically, the action allows for still new lows in bullion, but that remains to be seen.

This chart from Capital Int. Perspectives, 15 Rue du Cendrier, 1201 Geneva, Switz., gives us a very clear picture of what has happened to the gold shares over the past 7 years. This index is based on 30 S. African and N. American mines and 11 S. African finance houses. From below 100 in 1970, the index roared up to over 600 in 1974. A huge triangle formation was traced out during 1974-75, a formation which we now know was distribution.

In August of 1975 the golds fell out of the triangle and entered into one of the worst bear market collapses I have ever seen. By mid-1976 about 75% of all gold mine values were wiped out.

Guessing at bear market bottoms for stock groups is always a hazardous occupation. Certainly, the action of the last month must be considered a panic in gold shares. Bear markets often end with downside panic action.

Therefore, in view of the time element of the bear market, the severity of the recent chaotic panic action, and the current gold pessimism, I am guessing that we will see the lows for most gold shares in this area. But I would say that holding gold shares is an uninteresting proposition unless relative strength for the group turns bullish. It hasn't yet.

LATE MARKET NOTES: I always save this section for the last, because it allows me to include my latest comments on the market just prior to taking this report to the printer. If anything in the "Late Notes" section conflicts with earlier comments, it just can't be helped. These are always my last (and I hope my best) thoughts before wrapping it up.

The market has turned weak in the face of a cut in the prime rate, which is not particularly encouraging. I never relish selling on Wall Street while the good news emerges. Both Industrials and Transports (page 1 chart) have formed minor downward zig-zags, and the minor trend is therefore down.

Of interest is the fact that the Industrials Average is now only 4.5% above the 200-day moving average, the closest it has been to the MA since March. The 200-day MA now stands at about 940, and it has been rising at around 1 point per day (MA statistics from the computerized M/G Financial data). It would not surprise me to see the Dow come down and at least touch the 200-day MA.

Bonds and Utilities have been holding up well, and a continuation of a good Bond-Utility performance would be very constructive for the market on an intermediate and long-term basis. The tick volume (see last report) is down to only plus 400, and the ticks would have to break below minus 200 to take this index under the channel shown in the last report.

What worries me most is the A-D ratio. As you can see on the page 2 chart, this index is dropping very close to the trendline. If the bullish trendline on the A-D is broken, I am afraid it will be very difficult to get the A-D line up above the February 24 high. In that case, the best we can expect ahead is a long stall, or a series of trading swings which will probably be more frustrating than profitable. The worst we can expect is a protracted erosion or slide in breadth with stocks losing fractions and points for weeks on end.

TACTICS: The crux of this business, as far as I am concerned, is the "feel," the intuition--coupled with knowledge and experience. I guess the powers above have been good to me on the intuition end of it, and the experience I got the hard way, after thirty years of watching the markets (during which time I've also made every mistake in the books, but I've learned, too).

As all readers know, the thing I've been zero'd in on during the last few months is the A-D ratio. I can't say why I've felt that the story was being told here, but I did and I still do. And the way it's acting now is bothering me. This is a lone wolf business, and over and over again I've had to study the market, sweat over it, dream about it, wring my hands over it, pray for guidance regarding it, and then make my own decision. The tough part of it is that unlike medicine or law or most other occupations, there's no one else I can turn to for help or guidance. When you're writing about Wall Street and thousands of readers have to depend on you, then brother you're on your own, and you'd better not kid yourself about that one. I was on my own in 1966 when I called a bull market top, and I sure was on my own in December, 1974, when I called a bear market bottom.

You'd think you'd get used to sweating it alone, but I don't know if I ever will. I guess it's as Bob Dylan wrote, "It's hard, and it's hard and it's hard..." Now that I'm over feeling sorry for myself, I'll get down to it.

I now believe that it's time to be very careful. The A-D line has had five months to clear the February peak. It came within a hair of doing so on July 14, and failed. Now it is backing off and moving down to the trendline and the June low. Based on the action that I've seen right up to the time of this writing, the dribbling off of the A-D on low volume, I advocate cutting back, getting into a rather defensive position.

Take some profits, be prepared for some trouble, boost the size of your bond and cash position, and cut back on your stocks. We are at about the point where I suggest paying the cost of some insurance against the "unexpected." Is the second phase of the bull market ending here? I don't know yet, but it could be.

COMPARISONS: Comparisons are usually interesting, although at times they're valuable and at other times they're not worth a damn. At any rate, those of you who have the two historical chartbooks, the A-D book and the D-J book, might turn to the year 1957. That was the year when the second phase of the 1949-66 bull market ended.

The A-D ratio hit a high in January, 1957, slid off sharply into February, then tried for the next five months to better that January high. It never could. In July the A-D turned down in a vicious manner, together with the D-J Industrials and Transports. I remember that Summer and Fall well. The market fell apart into October while the public and Wall Street turned so bearish I couldn't believe it. All this was followed by the deep and scary 1958 recession.

After the drastic market correction, during early 1958, I turned very bullish. In fact, I started my business on the basis of my contrary bullishness. A bullish Dow Theory article which I wrote for Barron's in early 1958 was of tremendous help to me at that time, and happily, the article proved to be correct.

Note: The A-D ratio chartbook is available (1930-1975) for $35. The D-J Averages chartbook (1885-1975) for $49. Californians please add 6% sales tax. Immediate delivery on both, postage paid except for foreign.

Next Mailing: August 11